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Michigan's Changing Economy: The Impact on State Sales Tax Collections
By Gary S. Olson, Director

Much has been written in recent years regarding the changes that have been occurring in both the United States and Michigan economies. One of these changes involves the fact that personal consumption expenditures have been gradually shifting from the consumption of goods to the consumption of services. While Michigan consumers still purchase a large number of goods, there clearly is a trend toward the purchase of a greater level of services as a percentage of overall consumer expenditures. Purchases of such services as medical services, legal services, home services, and numerous other services have become an increasingly important component of the average consumer's overall expenditures.

This trend toward the purchase of services, at the expense of the purchase of goods by consumers, does have an impact on the collection of State tax revenue. This article examines this trend in the context of collections of the State sales and use tax. In Michigan, with few exceptions, the statutory base of the State sales and use tax includes the purchase of most goods, but excludes the purchase of most services. For example, if a Michigan consumer buys a lawnmower to mow his or her lawn, this purchase is taxable under the State sales tax. If the same Michigan consumer decides to have his or her lawn mowed by a private lawn care provider, the charge the consumer pays for this service is not subject to the State sales tax. This type of scenario affects the level of State sales and use tax collections.

In an effort to explore this shifting of consumer expenditures and its potential impact on State tax collections, the Senate Fiscal Agency has compared the taxable base of the State's sales and use taxes with the level of personal consumption in the State, measured by Michigan personal income, for the period fiscal year (FY) 1976-77 through FY 2002-03. Table 1 provides the data. During FY 1976-77, the base of the State's sales and use taxes equaled 49.8% of Michigan personal income. During FY 2002-03 the base of the State's sales and use taxes accounted for only 41.9% of Michigan personal income. As one can observe by carefully reviewing the data in Table 1, there has been a distinct downward trend in this percentage over the past 27 years. If the data are broken down into three periods of nine years each, the average for the FY 1976-77 through FY 1984-85 period equals 47.1%, the average for the FY 1985-86 through FY 1993-94 period equals 45.1%, and the average for the FY 1994-95 through FY 2002-03 period fell to 43.3%.

The overall trend toward the purchase of fewer goods and more services cannot entirely explain the decline in the taxable base of the sales and use tax. Other factors that have contributed to this decline include statutory exemptions to the base of the sales and use tax that have been enacted during this time period, and the trend toward consumers' purchasing goods by remote means, including catalog sales and internet sales. In most instances, these remote sales, while legally subject to collection under the State use tax, are made tax free by consumers. However, the trend toward the purchase of services by consumers is a significant part of this change.

This decline in the base of the sales and use tax as a percentage of Michigan personal income has had a significant impact on the level of sales and use tax collected by the State. For example, if during FY 2002-03, the base of the sales and use tax as a percentage of personal income had equaled the average level in the FY 1976-77 through FY 1984-85 period, total sales and use tax revenue in FY 2002-03 would have increased from the actual collection of $7.65 billion to the collection of $8.61 billion, an increase of $955 million or 12.5%.

As the Governor and the Legislature review State tax policy, it is important to understand that changes in economic behavior by consumers do have an impact on State tax collections. This point will have to be considered when any comprehensive review of the State tax structure is undertaken.

Table 1

Michigan's Sales and Use Tax Base (millions of dollars)

Fiscal Year	Sales/Use Tax Base	Michigan Personal Income	Sales/Use Tax Base as % of Personal Income
1976-77	$35,175	$70,666	49.8%
1977-78	39,673	78,812	50.3%
1978-79	43,480	87,544	49.7%
1979-80	43,408	93,265	46.5%
1980-81	46,018	101,114	45.5%
1981-82	45,450	104,608	43.4%
1982-83	49,463	109,162	45.3%
1983-84	56,058	120,635	46.5%
1984-85	62,100	131,316	47.3%
1985-86	66,848	140,998	47.4%
1986-87	68,655	145,970	47.0%
1987-88	71,593	154,344	46.4%
1988-89	77,278	166,096	46.5%
1989-90	78,630	174,411	45.1%
1990-91	78,655	179,536	43.8%
1991-92	80,453	189,586	42.4%
1992-93	85,880	199,577	43.0%
1993-94	93,758	213,413	43.9%
1994-95	97,118	226,193	42.9%
1995-96	103,442	234,309	44.1%
1996-97	108,034	245,823	43.9%
1997-98	112,943	260,778	43.3%
1998-99	119,745	274,918	43.6%
1999-00	127,215	291,485	43.6%
2000-01	128,098	294,537	43.5%
2001-02	129,105	298,153	43.3%
2002-03	127,540	304,593	41.9%
Average Percentage FY 1976-77 through FY 1984-85			47.1%
Average Percentage FY 1985-86 through FY 1993-94			45.1%
Average Percentage FY 1994-95 through FY 2002-03			43.3%

Source: Michigan Senate Fiscal Agency and the U.S. Department of Commerce, Bureau of Economic Analysis

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Low Income and Energy Efficiency Fund
By Maria Tyszkiewicz, Fiscal Analyst

In 2002, as a result of electric utility restructuring legislation, a Low Income and Energy Efficiency Fund (LIEEF) was created to provide assistance for low-income customers and to promote energy efficiency by all types of utility customers. The Customer Choice and Electricity Reliability Act of 2000, or Public Act 141, authorized the creation of this Fund, which is administered by the Michigan Public Service Commission (PSC). The Fund provides grants to various organizations and the Family Independence Agency to help provide utility shutoff protection and other energy-related financial assistance for low-income customers and to promote energy efficiency.

The revenue in the LIEEF comes from the savings that were realized as a result of allowing the regulated utilities to securitize what were considered "reasonable and prudent costs" with the approval of the PSC. Reasonable costs were determined to be those costs that were incurred by the regulated utilities under the regulated market that would be viewed as unrecoverable under a market-based system. Examples of these costs include investments in nuclear plants and changes in the tax code that would affect employee costs. The only utilities that met the requirements for securitization were the two regulated investor-owned utilities in Michigan, Detroit Edison and Consumers Energy. Prior to restructuring, these utilities accounted for approximately 90% of electricity sales and provided energy to approximately 88% of the State's electric customers.

The reasonable costs for these two utilities were identified and approved through a PSC order that authorized the utilities to securitize through the sale of bonds. The order determined the securitization amount for Detroit Edison at $1.8 billion and for Consumers Energy at $468 million. The ratepayers for the two utilities then would pay off these bonds as part of their rates. The interest rate on the bonds was lower than the rate of the original financing for these costs, thereby providing savings to the utilities. The statute further provided that the level of savings would be used to provide for a 5% rate reduction for both the residential and the industrial and commercial customers. Following these reductions, if additional savings existed, then the balance, up to 2% of the electric utility's commercial and industrial revenue, would be deposited into the LIEEF for six years or through 2006. The level of savings that was available from the Detroit Edison transaction was sufficient to meet both rate reductions and a deposit into the Fund. However, the level of savings resulting from the Consumers Energy transaction was much lower and never met the first two rate reductions necessary to require a deposit into the Fund.

The language in the statute requires that the LIEEF be used: "to provide shut-off and other protection for low-income customers and to promote energy efficiency by all customer classes". In November 2001 the PSC, through an order, established the procedures for which the Fund would operate, which included establishing three categories of grants that would be funded. The three categories are: energy assistance for low-income customers; conservation and energy efficiency measures targeted toward reducing the energy use of low-income customers; and the development of energy efficiency programs that benefit all customer classes. The funding then would be divided further with 75% for proposals under the first two categories and 25% for grants under the third category. A final goal of the order was to establish an endowment fund to assist low-income customers for the years following 2006. Since the creation of this Fund, there have been seven rounds of awards.

Table 1 shows the amount dispersed and the grant recipients. To date, Detroit Edison has remitted to the LIEEF $129 million, of which $104.4 has been awarded. Of this amount, $57 million has been allocated to the Family Independence Agency to provide supplemental payments to households receiving the Home Heating Credit ($24 million), for the expansion of the State Emergency Fund ($29 million), and for energy assistance special needs ($4 million). Of the seven grant rounds, only one round, at $12.2 million, was provided as grants for the purpose of developing or improving energy efficiency technologies. The remaining $92.2 million has been allocated to provide low-income energy assistance and for low-income energy efficiency projects. Of that amount, 62% was awarded for low-income energy assistance provided by the Family Independence Agency.

Table 1

Low-Income Energy Efficient Fund Grant Disbursements

Grant Recipient	Low-Income Energy Assistance	Energy Efficiency Technologies	Low-Income Energy Efficiency	Total
Family Independence Agency	$57,000,000			$57,000,000
Michigan Community Action Agency Association (MCAAA)	6,110,000		4,200,000	10,310,000
The Salvation Army	9,000,000			9,000,000
The Heat and Warmth Fund (THAW)	6,500,000		1,000,000	7,500,000
Newaygo County Community Services	545,675			545,675
Wayne Metropolitan Community Action Agency	212,987			212,987
Leslie Outreach, Inc.	34,109			34,109
Michigan Economic Development Corporation		4,200,000		4,200,000
Grand Valley State University		3,000,000		3,000,000
Bay de Noc Community College – Michigan Technical Education Center		2,000,000		2,000,000
Ford Motor Company		1,300,000		1,300,000
Sordal Incorporated		584,448		584,448
DTE Energy Technologies, Inc.		395,000		395,000
EnSave Energy Performance, Inc.		385,805		385,805
Intellicon		275,000		275,000
STM Power, Inc.		53,200		53,200

Low-Income Energy Efficient Fund Grant Disbursements				
Grant Recipient	**Low-Income Energy Assistance**	**Energy Efficiency Technologies**	**Low-Income Energy Efficiency**	**Total**
Community Economic Development Association of Michigan (CEDAM)			855,840	855,840
Consumers Energy Company			351,500	351,500
Metro Neighborhood Housing and Community Development			2,487,500	2,487,500
Nova Development Group of Detroit			2,006,146	2,006,146
The United Way Community Services/Nonprofit Facilities Center			1,115,000	1,115,000
Washtenaw Affordable Housing Corporation			26,000	26,000
Habitat for Humanity of Michigan			327,200	327,200
Urban Options, Inc.			244,490	244,490
WARM Training Center			209,000	209,000
TOTAL	**$79,402,771**	**$12,193,453**	**$12,822,676**	**$104,418,900**

Source: Michigan Public Service Commission

In February of this year, Detroit Edison applied to the PSC for rate relief. The Commission issued an interim order allowing an increase in rates for the utility. The increase was requested by the utility to assist in recovering some costs that have been associated with the transition to a market-based system. These costs were allowed to be recovered, but as a result of the rate increase, any savings that were being generated through securitization were eliminated. This order consequently eliminated the original funding source for LIEEF two years earlier than the statutory timeline had required. As a result, the PSC order instituted an additional surcharge on the ratepayers of Detroit Edison that will generate a similar amount of revenue for the Fund, estimated at $40 million per year. A final order from the Commission on this rate change is expected to be issued some time in October.

Following this rate change, the Senate included language in the Fiscal Year 2004-05 appropriations bill for the Department of Labor and Economic Growth (House Bill 5521), that would require the balance in the LIEEF, after the statutory obligation is made to the Community Action Agencies, to be distributed only in the Detroit Edison service territory. This would change the structure of the program from a statewide grant program to a more regional grant program, with only between $3 million and $5 million eligible to be distributed outside of the Detroit Edison service territory. The increase from $3 million to $5 million would be possible only if the Legislature does not enact a statewide low-income energy efficiency program funded by all regulated energy providers, which would include natural gas companies. Since this language was not included in the House-passed version of the bill, it will continue to be discussed in conference committee.

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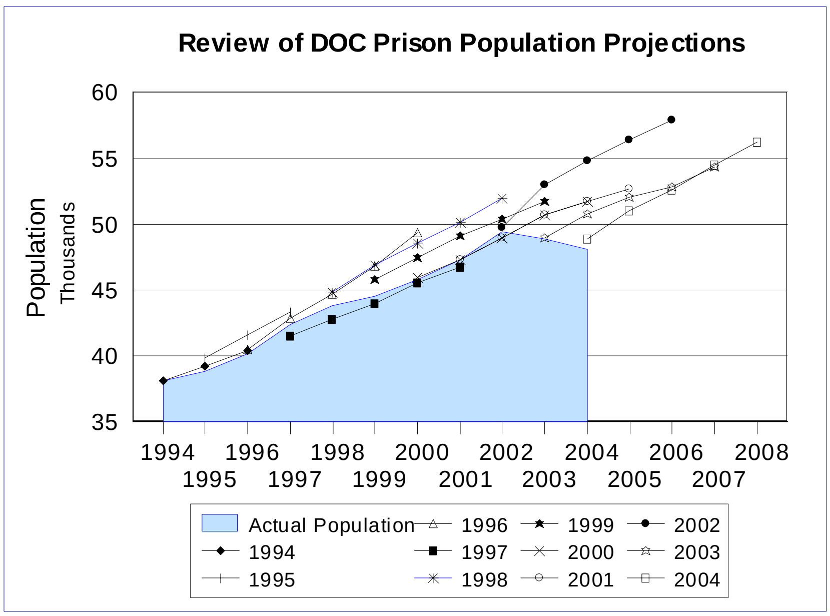
Prison Population Projections: A Review
By Bethany Wicksall, Fiscal Analyst

In a previous prison population update, the Senate Fiscal Agency reported that the Department of Corrections (DOC) had staunched the rapid increase in the prison population that occurred in 2002, but perhaps only by temporary means. The DOC's own population projections showed the population returning to its previous growth rates for the balance of 2003 and into the future. Population growth since has remained down, however, and the DOC ended 2003 with the first full-year population decline since 1983. Eight months into 2004, the population has continued to decrease, despite updated projections that again expected the contrary. This article provides a review of the Department's prison population projections and discusses the mitigating factors that help to explain some of the recent differences between the projections and actual growth.

Population Projections

Boilerplate language in the annual appropriation bill for the DOC requires that the Department provide three- and five-year prison population projections to the Legislature by February 1 of each year. In order to make these projections, the DOC uses a model that simulates population growth based on recent data regarding the existing prison population and an assumption of no change in legislation, administrative policy, or judicial practice. It takes into account various factors, including the number of felony dispositions, the distribution of sentence lengths among the existing population, and parole rates, as well as data on each of the four major components of population intake: newly committed inmates, probation technical rule violators, parole technical rule violators, and parolees with new sentences. The Department of Corrections staff also may include assumptions in order to adjust for changes the data will not yet reflect or to correct for what they know will be simply a one-time or short-term phenomenon. The model then produces a potential population trend line for the next five years. Figure 1 shows these annual projections for the last 10 years as compared with the actual growth of the prison population.

Figure 1



Source: MDOC Prison Population Projections and Data Fact Sheets.

It often has been true that the actual population has grown less than the DOC anticipated in its projections. The DOC acknowledges that it errs on the conservative side in order to prevent running out of beds and crowding, which can create both budgetary and safety concerns. Given that new construction takes up to three years, the Department feels that it cannot afford to underestimate its future bed needs. Table 1 shows the overall percentages by which the projections were different from the actual population by the end of each year for which they were made. As can be expected, the projections are nearly accurate for the first year but become less so further into the future. On average the projections are off by 1.2% in either direction for the first year and 5.37% by year five. Given that this type of trend modeling is an imprecise science and that population growth is heavily influenced by policy changes, these projections are fairly accurate. It also is noteworthy, however, that 5% of a population of 48,000 prisoners is 2,400. This is slightly higher than the average number of beds in two prisons, so relying too heavily on long-term projections can lead to the construction of unnecessary facilities.

Table 1

Percent Difference of Projections from Actual Prison Population

	Number of Years Out				
Projection Year	**1**	**2**	**3**	**4**	**5**
1994	-0.14%	1.06%	0.60%	N/A	N/A
1995	2.54%	3.59%	2.17%	N/A	N/A
1996	0.88%	1.03%	2.02%	5.31%	7.68%
1997	-2.17%	-2.31%	-1.08%	-0.58%	-1.16%
1998	2.37%	5.37%	5.99%	6.05%	5.05%
1999	2.87%	3.63%	3.84%	1.90%	5.85%
2000	0.30%	-0.03%	-0.97%	3.73%	7.08%
2001	-0.03%	-0.97%	3.73%	7.08%	
2002	0.59%	8.38%	13.50%		
2003	0.23%	5.05%			
Average Absolute Value	**1.21%**	**3.14%**	**3.77%**	**4.11%**	**5.37%**

Source: Senate Fiscal Agency

Mitigating Factors

It also is true that a population projection warning of an impending dearth of beds can lead to policy and administrative changes, which if successful in limiting population growth, quickly will make a projection outdated and seemingly overestimated. This can be seen from the events of the past few years. The 2000 and 2001 projections were initially quite accurate. During the second half of 2001, however, two things began to happen. Prison intake began to climb faster than expected, and the number of prisoners participating in community residential programs fell more quickly than the DOC had anticipated it would. Without enough data to explain why either of these events was taking place, the DOC postponed making the 2002 population projections. When the DOC did finally release projections in December 2002, these trends had exacerbated, growth had climbed to over 5%, and the Department expected to run out of beds by the fall of 2003. In order to prevent that from occurring, the DOC took immediate steps to address the issue. Initially, these included approving earlier parole dates for offenders who had been approved for release at a later date (fixed-date paroles); encouraging parole officers to use more community sanctions for parole technical violators rather than sending them back to prison; and implementing a parole violator diversion program in which offenders who returned to prison could receive six-month continued prison sentences instead of the typical 12- to 18-month continuances.

These changes created an immediate impact on population growth, which was furthered in early 2003 by the elimination of mandatory minimum sentences for drug offenders, making a number of first-time, nonviolent offenders immediately eligible for parole, as well as the implementation of the first two phases of the DOC's five-year plan to reduce population growth. This included reducing prison commitment rates for offenders with short sentences through increased collaboration with community corrections programs; emphasizing the use of drug courts and treatment programs for substance abuse and drunk-driving offenders; and expanding the use of community residential programs for prisoners past their earliest release date. The Department also began to see an increase both in the number of parole decisions and in the parole approval rates. Again, the DOC waited to release projections until August 2003 when it had a better grasp of how these changes would play out. Despite having seen decreases in the population for the first time in many years, the Department was cautious about its ability to maintain those trends without the addition of sentencing guidelines revisions and the success of the prisoner re-entry initiative to create long-term population reductions. Thus, the 2003 population projection showed the population resuming a growth rate resembling recent experiences.

The 2004 projection released just five months later proceeded in a similar manner. It recognized the continued decline in the prison population, which pushed the run-out-of-beds date back from September 2003 to August 2005. (The beds counted, however, do not include approximately 1,500 in the Michigan Reformatory and Jackson Maximum facilities, which are both currently vacant but unfunded.) Nevertheless, the DOC was still reluctant to rely on the short-term solutions it had used, and forecasted a return to 3.5% growth absent other long-term initiatives. Instead, the prison population has fallen another 1% in 2004 and is currently 700 offenders fewer than the most recent projections anticipated. A continued decline in the two largest segments of the intake population, new commitments and probation violators, as well as an increase in parole rates, which have climbed from 48.4% in 2002 to 54.2% this year, have helped maintained this downward trend. It remains to be seen, however, how long the trend will last, and whether other initiatives will control population growth enough to avoid further prison construction.

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A Brief History of the Michigan Casino Gaming Tax
By David Zin, Economist

In November 1996, 51.5% of Michigan voters approved Proposal E, which effectively authorized the licensing and operation of three casinos within the City of Detroit. Proposal E (1996 Initiated Law) enacted the Michigan Gaming Control and Revenue Act (MCL 432.201 et seq). Included in Proposal E were provisions for a tax on receipts any casinos might receive. The provisions were later modified by Public Act 69 of 1997, which substantially rewrote the Michigan Gaming Control and Revenue Act. Those provisions recently were modified again with the enactment of Public Act (P.A.) 306 of 2004 (House Bill 4612).

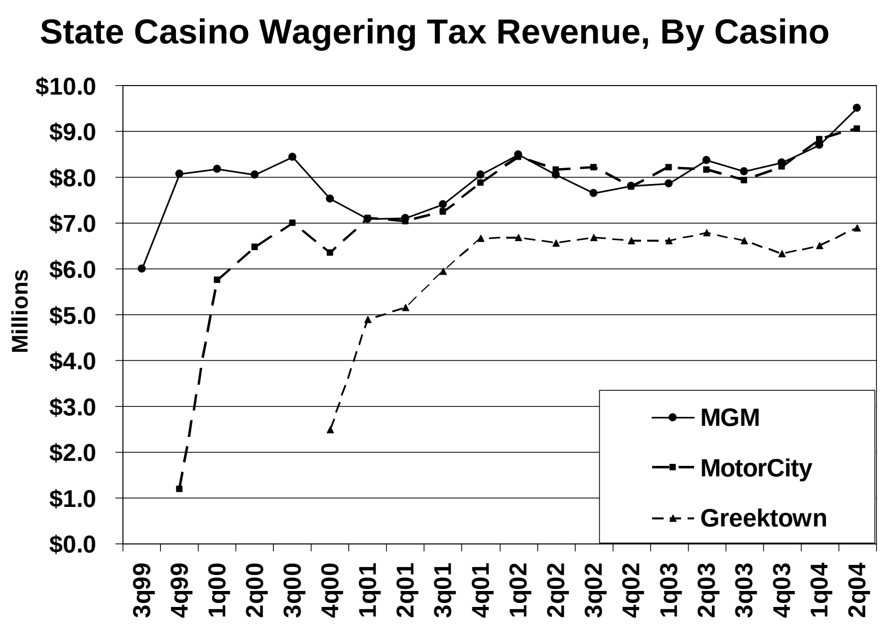
Under Proposal E, the State levied an 18% tax on the gross revenue received by a casino licensee. Gross revenue was defined as the total of all cash received as winnings, cash received in payment for credit extended by the casino to a patron for gaming purposes, and compensation received for conducting games in which the casino licensee was not party to a wager. Proposal E then distributed the revenue from the tax, with the State School Aid Fund receiving 45% of the revenue and the remaining 55% going to Detroit for use in connection with public safety, economic development programs, antigang and youth development programs, and other programs designed to improve the quality of life in the city.

Public Act 69 of 1997 changed the tax base to adjusted gross receipts, which was defined as the total of all sums received by a casino licensee from gaming less any winnings paid to wagerers. The Act also allowed the City of Detroit to impose its own wagering tax, or similar revenue-generating mechanism, at a 9.9% rate. If the Detroit wagering tax were enacted, which would require the approval of Detroit voters, then the State's tax rate would drop to 8.1% and all of the revenue would be deposited into the School Aid Fund. Detroit voters approved the new tax on November 4, 1997.

The Gaming Control and Revenue Act also provides for a number of other fees for the casinos to pay. Fees and taxes are paid to both the State and the City of Detroit. In addition to the 8.1% State wagering tax, each casino pays an annual licensing fee of $25,000 and an annual State Services Fee equal to one-third of $25.0 million, which is adjusted each year for inflation. Each casino also paid the State a one-time application fee of $50,000. The City of Detroit also receives an annual municipal services fee of $4.0 million from each casino.

The first commercial casino license granted under the law was issued July 28, 1999, to the MGM Grand Detroit, LLC, doing business as the MGM Grand Detroit Casino. On December 14, 1999, another license was issued to Detroit Entertainment, LLC, doing business as MotorCity Casino. The last license was issued November 8, 2000, to Greektown Casino, LLC, doing business as Greektown Casino. State gaming tax revenue received from each casino is illustrated in <u>Figure 1</u>.

Figure 1



Source: Michigan Gaming Control Board

The tax and fee structure for the Detroit casinos remained unchanged from 1997 until August 2004. In August 2004, P.A. 306 of 2004 made several changes to the taxes levied on the casinos, effective September 1, 2004. The key provisions of P.A. 306 of 2004:

- Impose an additional gaming tax on a casino's adjusted gross receipts.
- Distribute revenue from the additional tax to the City of Detroit, the State General Fund, and the Michigan Agriculture Equine Industry Development Fund.
- Increase the additional tax on any casino licensee that is not fully operational by certain dates.
- Reduce a casino's additional tax to 1%, and allocate it entirely to the City of Detroit, if the Gaming Control Board finds that the casino is fully operational and in compliance with its development agreement for at least 30 consecutive days.
- Eliminate the Act's additional taxes and allow the casinos to simulcast horse races if the Lottery Act is amended to allow the operation of video lottery at horse racetracks and video lottery is being conducted.

The Act provides for a number of circumstances that control the administration of the tax and how the revenue is to be divided. Although not described this way in the Act, it effectively creates two additional taxes: an additional State wagering tax and an additional Detroit wagering tax. The additional State tax is imposed at a rate of 4% and 1/8 of the revenue will be allocated to the Michigan Agriculture Equine Industry Development Fund while the State

General Fund will receive the remaining 7/8 of the revenue. As discussed below, casinos will no longer be obligated to pay this portion of the tax once the permanent casinos are fully operational or if and when video lottery is operational at Michigan horse racetracks.

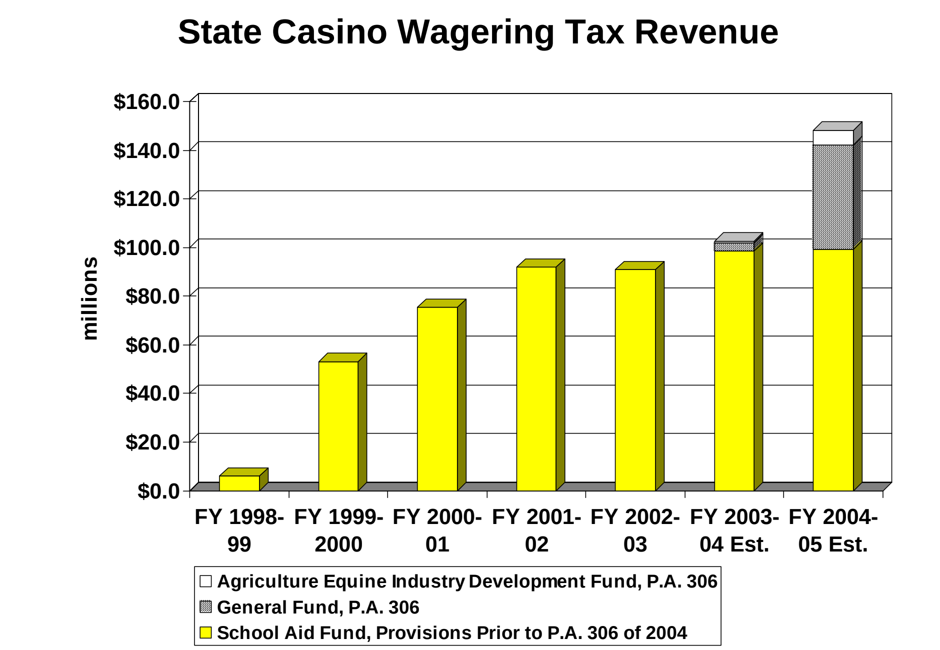
For the portion of the tax that is effectively an additional Detroit wagering tax, the City of Detroit will receive all of the revenue and it must be used for the same purposes as authorized for revenue under the pre-existing 9.9% wagering tax. The tax rate for the effective additional Detroit wagering tax depends upon whether or not a given casino is certified to be fully operational. Public Act 306 of 2004 defines "fully operational" to mean that the casino is operating at its permanent location and has a 400 or more room hotel with a valid certificate of occupancy. Until July 1, 2009, the effective additional Detroit wagering tax rate on that casino is 2.0%. If a casino is not fully operational by July 1, 2009, the effective additional Detroit wagering tax on that casino will be increased from 2% to 3%. If a casino is not fully operational by July 1, 2010, the effective additional tax will be increased to 4%, and if the casino is still not fully operational by July 1, 2011, the effective additional tax will be increased again, to 5%. Once a casino is certified to be fully operational, the additional tax will be lowered to 1% and allocated entirely to the City of Detroit.

Public Act 306 of 2004 also provides that if the Lottery Act is amended to allow video lottery to be operated at horse racetracks in Michigan, and video lottery is operational, casinos no longer will be obligated to pay any additional tax imposed by the Act. In addition, if and when video lottery is operational, casinos will be allowed to become authorized to simulcast horse races. Should a casino begin to simulcast horse racing, those operations will be regulated by both the Horse Racing Commissioner and the Michigan Gaming Control Board. Furthermore, the casino will be entitled to the identical commissions, taxes, fees, and deductions associated with simulcast wagering at horse racetracks.

Both State General Fund and City of Detroit revenues will increase as a result of P.A. 306 of 2004. Assuming that no casinos begin operating permanent facilities during either fiscal year (FY) 2003-04 or FY 2004-05 and that video lottery is not yet being conducted in Michigan, in FY 2003-04 the Act will increase State General Fund revenue by approximately $3.6 million, State Agriculture Equine Industry Development Fund revenue by $0.5 million, and City of Detroit revenue by $2.1 million. Under the same assumptions, in FY 2004-05 the Act will increase State General Fund revenue by $42.9 million, State Agriculture Equine Industry Development Fund revenue by $6.1 million, and City of Detroit revenue by $24.5 million, as shown in Figure 2.

It is unknown when the permanent casinos will begin operation, although current estimates suggest that the earliest any will be operational will be during 2006 or 2007. Similarly, it is unknown if and when video lottery terminals will become operational. Should video lottery become operational and casino licensees begin offering simulcast racing, current law requires that revenue from simulcast wagering be deposited in the Michigan Agriculture Equine Industry Development Fund, which distributes revenue to community fairs and racing industry program grants.

Figure 2



Source: Michigan Senate Fiscal Agency